SUPREME COURT, U. S.

No. 73-1017

In the Supreme Court of the United States

OCTOBER TERM, 1973

Supreme Court, U. S.
FILED
DEC 28 19
MICHAEL RODAK, JR.

UNITED STATES OF AMERICA, PETITIONER

v.

WALT DISNEY PRODUCTIONS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes and regulations involved	2
Statement	3
Reasons for granting the writ	5
Conclusion	18
Appendix A	1a
Appendix B	10a
Appendix C	17a
Appendix D	18a
Appendix E	20a

CITATIONS

Cases:

American Tobacco Co. v. *Werckmeister*, 207 U.S. 284	12
Brewster v. *Gage*, 280 U.S. 327	11
Commissioner v. *Bilder*, 369 U.S. 499	17
Commissioner v. *Korell*, 339 U.S. 619	10
Commissioner v. *South Texas Co.*, 333 U.S. 496	11
Crane v. *Commissioner*, 331 U.S. 1	10
Hanover Bank v. *Commissioner*, 369 U.S. 672	10
Italiani v. *Metro-Goldwyn-Mayer Corp.*, 45 Cal. App. 2d 464, 114 P.2d 370	12

Cases—Continued

	Page
King Bros. Productions, Inc. v. *RKO Teleradio Pictures, Inc.*, 208 F. Supp. 271	12
Kiro, Inc. v. *Commissioner*, 51 T.C. 155	13
Lucas v. *American Code Co.*, 280 U.S. 445	11
Malat v. *Riddell*, 383 U.S. 569	10
Michael Todd Company v. *County of Los Angeles*, 371 P.2d 340	14
Millar v. *Taylor*, 4 Burr. 2303, 98 English Reports (Reprints) 201	12
Misbourne Pictures Limited v. *Johnson*, 189 F. 2d 774	13
Pickford Corp. v. *De-Luxe Laboratories*, 161 F. Supp. 367	12
Rainwater v. *United States*, 356 U.S. 590	16
Stephens v. *Cady*, 55 U.S. 528	12
Stevens v. *Gladding*, 58 U.S. 447	12
United States v. *Chicago, Burlington & Quincy R.R. Co.*, October Term, 1972, No. 72-90 (decided June 4, 1973)	7
United States v. *Correll*, 389 U.S. 299	11
United States v. *Mine Workers*, 330 U.S. 258	16
United States v. *Philadelphia Nat. Bank*, 374 U.S. 321	16
United States v. *Price*, 361 U.S. 304	16
United States v. *Southwestern Cable Co.*, 392 U.S. 157	16
United States v. *Webb, Inc.*, 397 U.S. 179	16
Universal Film Mfg. Co. v. *Copperman*, 218 Fed. 577, certiorari denied, 235 U.S. 704	15

Cases—Continued

	Page
Waterman S.S. Corp. v. *United States*, 381 U.S. 252	16

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 38	2, 4, 11, 20a
Sec. 46	2, 4, 20a
Sec. 47	21a
Sec. 48	22a
Sec. 48(a)(1)(A)	2, 4, 5, 9
Sec. 49	7
Sec. 50	7
17 U.S.C. 27	12

Miscellaneous:

American Institute of Certified Public Accountants, *Accounting for Motion Picture Films*, pp. 10-12 (1973 ed.)	13
109 Cong. Rec., p. 13379	10
117 Cong. Rec. 34894	16
117 Cong. Rec. 45865	16
General Explanation of the Revenue Act of 1971, Staff of the Joint Committee on Internal Revenue Taxation, December 15, 1972	17
H. Conf. Rep. No. 2508, 87th Cong., 2d Sess.	8
H. Rep. No. 1447, 87th Cong., 2d Sess.	8, 9
H. Rep. No. 92-533, 92d Cong., 1st Sess.	7
H. R. 7786, 88th Cong., 1st Sess.	10
Rev. Rul. 60-358, 1960-2 Cum. Bull. 68	13
S. Rep. No. 1881, 87th Cong., 2d Sess.	8, 9

Miscellaneous—Continued Page

S. Rep. No. 92-437, 92d Cong., 1st Sess. 7, 16, 17
Senate Hearings before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess. 9
Treasury Regulations on Income Tax:
Section 1.38-1 24a
Section 1.46-1 24a
Section 1.46-3 24a
Section 1.48-1(f) 4, 10-11, 17, 26a

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The memorandum opinion of the District Court (Appendix A, *infra*, pp. 1a-9a) is reported at 327 F. Supp. 189. The opinion of the court of appeals (Appendix B, *infra*, pp. 10a-16a) is reported at 480 F. 2d 66.

JURISDICTION

The judgment of the court of appeals was entered on May 29, 1973 (Appendix C, *infra*, p. 17a). A petition for rehearing and suggestion for rehearing *en banc* was denied on July 31, 1973 (Appendix D, *infra*, pp. 18a-19a). By order dated October 18, 1973, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including December 28, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Sections 38, 46 and 48(a)(1)(A) of the Internal Revenue Code of 1954 allow an investment credit against income tax equal to a maximum of seven percent of the costs incurred in the acquisition or construction of "tangible personal property." The question presented is whether the costs of producing a motion picture for theatrical or television exhibition are costs incurred in the acquisition or construction of "tangible personal property" within the meaning of the latter provision so as to be eligible for the investment credit.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix E, *infra*, pp. 20a-30a.

STATEMENT

Respondent is a California corporation which produces and distributes motion pictures. By late 1961, respondent had produced more than 100 pictures, positive prints of which were exhibited either in motion picture theaters or on television (Appendix A, *infra*, pp. 1a-2a; R. 892-893).[1]

The production of a motion picture involves a wide variety of expenditures culminating in the creation of an original negative, which is then used to make a matrix. The matrix is in turn used to make positive prints to be rented or sold for exhibition to the public (Appendix A, *infra*, p. 2a; Ex. 11, p. 8). The expenditures involved in the production of a motion picture include: (1) the cost of acquiring or creating literary property; (2) salaries to the producer, director, writers, technicians, wardrobe personnel and set decorators; (3) salary to regular cast and extras; (4) costs of set construction and costumes; (5) special effects; (6) music; (7) transportation to and from location; (8) film; (9) laboratory and processing of work prints; (10) living expenses on location; and (11) an allocable share of employee benefits and general studio overhead (R. 884-887).

During the period January 1, 1962, through September 29, 1962, respondent incurred $1,416,573 of

[1] "R." references are to the duplicated volumes of the record on appeal. We have lodged a copy of each volume with the Clerk of this Court. We have also lodged a copy of Exhibit 11 (Amended Stipulation of Facts) with the Clerk.

such costs in the production of eight motion pictures (Appendix A, *infra*, pp. 1a-2a). On its income tax return for its taxable year ended September 29, 1962, respondent claimed an investment credit under Sections 38, 46 and 48 of the Internal Revenue Code of 1954 of $99,160, which was equal to seven percent [2] of its motion picture production costs of $1,416,573 (Appendix A, *infra*, p. 2a).

The Commissioner disallowed the credit on the ground that the costs of producing the motion pictures did not constitute the acquisition or construction of "tangible personal property" within the meaning of Section 48(a)(1)(A). The Commissioner's disallowance of the claimed credit was on the authority of Treasury Regulations, Section 1.48-1(f). This Regulation specifically provides that motion picture production costs are attributable to the acquisition of intangible property and are therefore ineligi-

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[2] Generally, the amount of the credit is equal to seven percent of a taxpayer's "qualified investment" (Section 46(a)(1)), which is defined as "the applicable percentage" of the basis of "new section 38 property" (*i.e.*, property constructed, reconstructed, erected or acquired by the taxpayer (Section 46(c)). The "applicable percentage" varies with the useful life of the property, determined as of the time it is placed in service by the taxpayer. Property with a useful life of eight years or more is fully taken into account in computing the "qualified investment." If the useful life is less than eight years, but more than four, a lesser percentage of the basis is employed in computing the investment credit (Section 46(c)(2)). Although respondent amortized most of the costs of its motion pictures over a three-year period, it estimated the useful life of the negatives to be eight years or more, thereby enabling it to claim the maximum credit.

ble for the investment credit (R. 891; Ex. 11, pp. 3-4).

Because motion picture negatives are "capable of being seen and touched," the district court concluded that they were "tangible personal property" within the meaning of Code Section 48(a)(1)(A). It held the Commissioner's Regulation invalid and included all of respondent's motion picture costs[3] in its investment credit base (Appendix A, *infra*, pp. 6a-9a). The court of appeals affirmed. Relying upon certain statements in the legislative history with respect to the restoration of the investment credit in the Revenue Act of 1971, it held that the Commissioner's Regulation was inconsistent with the purpose of the investment credit (Appendix B, *infra*, pp. 10a-16a).

REASONS FOR GRANTING THE WRIT

1. The decision of the court of appeals allowing the investment credit on virtually all of the costs of motion picture production from 1962 through 1969 of films made for both theatrical and television exhibition will result in a potential loss of tax revenues to the federal government of between 400 and 450 million dollars.[4]

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[3] The district court excluded from the investment credit base one minor aspect of respondent's costs, the cost of rejected film footage (Appendix A, *infra*, pp. 8a-9a). The court of appeals, however, allowed the investment credit on such costs (Appendix B, *infra*, p. 16a).

[4] Although the present case involves a claim of only $99,160 for a single year, respondent has indicated that for its taxable

The Internal Revenue Service, on the basis of information with respect to the addresses of more than 700 domestic motion picture producers, has concluded that approximately 75 percent of them will be able to sue in the Ninth Circuit, because their offices or principal places of business are in California. The investment credit is a direct offset against income taxes otherwise payable by firms who can claim the credit. The Service estimates that comparable and potential claims for the investment credit which the court of appeals decision allows by the major motion picture producers for open tax years during the period 1962-1969 would create a potential loss of federal tax revenues of almost half a billion dollars.[5]

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years 1962 through 1969, its motion picture costs were at least $100 million, upon which it has claimed the maximum seven percent credit, which totals at least $7 million, excluding interest. See page 5 of an affidavit dated November 14, 1972, of John Cooley Baity, one of respondent's counsel in the court of appeals. This affidavit was filed in the court of appeals in support of a motion for a preference in calendaring the oral argument. We have lodged a copy of this affidavit with the Clerk.

[5] In addition to the instant case, the same issue is present in at least five other cases now pending in the Court of Claims, all of which were brought after the decision of the district court in this case. The taxpayers and the amounts at issue are as follows: *RCA Corp.* v. *United States*, No. 142-73 ($4,223,743 for 1965-1966); *RCA Corp.* v. *United States*, No. 675-71 ($352, 682 for 1964); *National Broadcasting Co.* v. *United States*, No. 676-71 ($485,287 for 1962-1963); *Columbia Broadcasting System, Inc.* v. *United States*, No. 679-71 ($1,141,210 for taxable year ended January 2, 1965); and *Esquire, Inc.* v. *United States*, No. 169-73 ($34,736 for taxable year ended March 31, 1966).

Although the impact of the Ninth Circuit's decision may be limited to the period 1962 through 1969,[6] it will nevertheless, as this Court stated only last Term under similar circumstances, "afford a precedent for the tax treatment of substantial sums." *United States* v. *Chicago, Burlington & Quincy R.R. Co.*, October Term, 1972, No. 72-90 (decided June 4, 1973) (Slip op. 4).[7]

In view of the importance of the issue and the fact that the decision of the Ninth Circuit will control the major portion of similar claims by the motion picture industry, there is no occasion to await the development of a possible conflict of decisions through future litigation. The decision below itself will have an enormous impact upon the federal fisc, since it

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[6] The investment credit generally was terminated for property acquired after April 18, 1969, and for property the physical construction, reconstruction, or erection of which began after April 18, 1969. See Code Section 49, added by Section 703(a), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487. It was restored, and to some extent modified, by the addition to the Code of Section 50 by Section 101(a) of the Revenue Act of 1971, P.L. 92-178, 85 Stat. 497. In the legislative history of the restoration of the investment credit in the Revenue Act of 1971 (H. Rep. No. 92-533, 92d Cong., 1st Sess.; S. Rep. No. 92-437, 92d Cong. 1st Sess.), Congress apparently indicated a desire to extend the investment credit by carving out a legislative exception under which motion picture and television film costs would be deemed attributable to the construction of tangible personal property.

[7] There, as here, the issue had been apparently settled by legislation governing subsequent years. This fact, however, did not minimize the importance of the question for purposes of review by this Court because of the substantial amounts at stake for the period with respect to which the issue remained unsettled.

will permit a direct offset from tax liability of an amount equal to a maximum of seven percent of the entire overhead of most American film producers for the years 1962 through 1969. A decision with such far reaching impact calls for review by this Court now.

2. In extending the investment credit for motion picture production costs, the decision below is contrary to the Congressional purpose in originally enacting the investment credit. The credit was introduced as part of the Revenue Act of 1962, in order to stimulate the domestic economy and to improve the balance of payments deficit by encouraging the modernization and expansion of the nation's productive facilities and by reducing "the net cost of acquiring new equipment." [8] Nothing in the history of the Revenue Act of 1962, however, suggests that Congress also intended this legislation to encourage the production of entertainment vehicles such as motion pictures.

Quite the contrary is true. The legislative history shows that Congress did not intend the investment credit to apply to costs of purchasing personal services necessary for the creation of artistic or literary properties such as a motion picture. In discussing the requirements for eligibility, both the House and Senate Committee Reports accompanying the 1962 Act stated that "Intangible property, such as patents

[8] S. Rep. No. 1881, 87th Cong., 2d Sess., p. 11; see also H. Rep. No. 1447, 87th Cong., 2d Sess., pp. 7-9; and H. Conf. Rep. No. 2508, 87th Cong., 2d Sess., p. 14.

and copyrights, does not qualify as section 38 property." S. Rep. No. 1881, *supra*, p. 154; H. Rep. No. 1447, *supra*, p. A18.[9]

Moreover, the very language of the investment credit provisions confirms the Congressional understanding that the credit was not to apply to motion picture production costs, other than the cost of facilities such as lights, cameras, and similar equipment. The credit only applies to "new section 38 property." With respect to property created by the taxpayer's own efforts, this term is defined in Section 48(a)(1)(A) and (b) as "tangible personal property" the "*construction, reconstruction, or erection* of which is completed by the taxpayer after December 31, 1961" (emphasis added).

By using the terms "construction," "reconstruction," or "erection," Congress limited eligibility for the credit to property the creation of which would

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[9] Congress was not unaware when it limited the investment credit to tangible property that motion pictures were intangible property. Significantly, in 1962, in its consideration of the legislation proposing the investment credit, the Senate Finance Committee heard testimony from Eric Johnston, President of the Motion Picture Association of America (Senate Hearings before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess., pp. 3518-3524. He stated (p. 3519): "If our product was a toaster or a washer, or any other patented or processed commodity, it would be clear that we should be treated like all others engaged in a trade or business. But our product is a motion picture—entertainment, art, an image of light and shadow projected on a screen." Although detailed legislative proposals were suggested to assist the industry, nothing was enacted, much less even reported out of committee. Notably, no proposal was made to extend the investment credit to motion picture production costs.

literally fit within the "ordinary, everyday senses" of these words.[10] The process by which a photoplay is superimposed upon celluloid in order to create a completed negative is neither "construction" nor "erection" in the normal sense of these terms. One does not "construct" or "erect" a motion picture; one "produces" it. A motion picture is not "new section 38 property" as the statute defines that term.

If Congress had intended motion picture production costs to be eligible for the investment credit, it knew how to say so in unequivocal terms. This is shown by a bill (H.R. 7786, 88th Cong., 1st Sess.), introduced on July 25, 1963, by Representative King of California, then the second ranking majority member of the House Committee on Ways and Means. The bill, which was never reported, would have amended the definition of "section 38 property" set forth in Code Section 48(a) to include "motion picture and television films and tapes which are produced within the United States." See 109 Cong. Rec. 13379.

3. In the light of the policy of the investment credit as originally enacted, the Treasury Regulation, struck down by the decision below, is entirely consistent with the Congressional understanding that motion picture production costs are not eligible for the credit. Treasury Regulations, Section 1.48-1(f), provides as follows:

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[10] See, *e.g.*, *Malat* v. *Riddell*, 383 U.S. 569, 571; *Crane* v. *Commissioner*, 331 U.S. 1, 6; *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 687-688; *Commissioner* v. *Korell*, 339 U.S. 619, 627-628.

> * * * Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. *Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape.* In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. * * * [Emphasis added.]

Quite apart from the teachings of this Court that a Treasury Regulation must be sustained unless unreasonable or plainly contrary to the legislative mandate (*United States* v. *Correll*, 389 U.S. 299, 306-307; *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501),[11] the Regulation in question correctly recognizes the nature and relative values of the property interests inherent in the ownership of a motion picture, as reflected in the decisions of this Court and

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[11] Moreover, in view of the special delegation to the Commissioner in Section 38(b), Appendix E, *infra*, p. 20a, to "prescribe such regulations as may be necessary to carry out the purposes [of the investment credit]," the Regulation in question is entitled to more than the usual great weight accorded such administrative constructions and should not be overturned unless clearly unlawful. *Brewster* v. *Gage*, 280 U.S. 327, 336; *Lucas* v. *American Code Co.*, 280 U.S. 445, 449.

others. In invalidating the above-quoted Regulation, the decision of the court of appeals is contrary to virtually every existing authority dealing with the nature of the interest a motion picture represents.

Theatrical or television films, like other forms of literary property, consist of at least two distinct types of property rights: the negative, a celluloid film which is tangible; and the photoplay, the images impressed upon the celluloid and the sound track, and the accompanying rights to distribute and exhibit that artistic creation, which are intangible. *Pickford Corp.* v. *De-Luxe Laboratories*, 161 F. Supp. 367 (S.D. Cal.); *King Bros. Productions, Inc.* v. *RKO Teleradio Pictures, Inc.*, 208 F. Supp. 271 (S.D. N.Y.); *Italiani* v. *Metro-Goldwyn-Mayer Corp.*, 45 Cal. App. 2d 464, 466, 114 P. 2d 370, 372. The latter aspect of ownership is a copyright because it includes the right to make copies of the fruits of the intellectual and artistic endeavors, to publish and exploit them commercially, and to preclude all others from duplicating the work. These rights have been universally held to be intangible. *Millar* v. *Taylor*, 4 Burr. 2303, 2396, 98 English Reports (Reprints) 201, 251; *Stephens* v. *Cady*, 55 U.S. 528; *American Tobacco Co.* v. *Werckmeister*, 207 U.S. 284, 298. Moreover, these intangible rights known as copyrights have been long held to be separate and distinct from the material object which is copyrighted and even from the particular physical means utilized to create the copies. *Stephens* v. *Cady, supra; Stevens* v. *Gladding*, 58 U.S. 447, 452; 17 U.S.C. 27.

In attributing all of the motion picture production costs to the tangible celluloid film, the court of appeals failed to perceive that the essential value of a motion picture arises out of its intangible aspects, particularly the exclusive right to make copies of and to exploit the intellectual and artistic endeavor which has been embodied in the negative.[12] In recognition of this fact, the Second Circuit stated in *Misbourne Pictures Limited* v. *Johnson*, 189 F. 2d 774, 776: "The essential subject matter of the contract was the rights of distribution granted to Goldwyn, not possession of the negative. The latter without the former would have been of relatively little value to either party." For this reason, if for no other, the greatest part of the cost of a produced film (or video tape) is properly attributable to the intangible photoplay. And it is precisely in recognition of the fact that the value of a motion picture resides in its intangible element that the Regulations treat motion picture production costs as an investment in nonqualifying

[12] The practice with respect to depreciation of motion pictures similarly recognizes that the chief value of such films lies in the right to exploitation. Depreciation is computed under the "income forecast" method and not by reference to the physical life of the negative. See Rev. Rul. 60-358, 1960-2 Cum. Bull. 68. The motion picture industry itself recognizes the propriety of this method. See American Institute of Certified Public Accountants, *Accounting for Motion Picture Films*, pp. 10-12 (1973 ed). See also *Kiro, Inc.* v. *Commissioner*, 51 T.C. 155, 172-173.

intangible property.[13] Indeed, to attribute the costs incurred in producing a motion picture to the tangible negative may be analogized to attributing the costs of litigation to the tangible transcript of a trial or the

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[13] With the exception of this case, the motion picture industry itself has always recognized that the essential value of a motion picture is attributable to the intangible property rights. Indeed, it so argued in *Michael Todd Company* v. *County of Los Angeles*, 371 P.2d 340 (Cal. Sup. Ct.). The question in that case was whether a local *ad valorem* property tax assessment on motion pictures could include the value of the copyright and other intangible rights inherent in the film. In its *amicus curiae* brief filed on behalf of the studio, the Association of Motion Picture Producers argued (pp. 17-18):

> Concededly, the essential value in motion picture negatives arises out of the copyright, that is, the owner's exclusive right to make copies of and to exploit the intellectual and artistic endeavor which has been embodied in the negative. Judicial notice was taken of this fact in *Pickford Corporation* v. *De-Luxe Laboratories*, 161 Fed. Supp. 367, 369 (S.D. Cal.) and it is also conceded by the stipulated fact in the present case that the value of the negatives, in the hands of one who did not possess the copyright would be only $1,000 for salvage uses while the assessed value of the negatives, in which assessment the right to use the copyright was taken into account, was $1,500,000. Whatever the semantics employed which attempt to justify such an assessment, the ultimate result is to levy a tax on the entire bundle of intangible rights which flow from the copyright itself and, as a consequence, to tax the copyright to the owner.

Although the California Supreme Court held against the motion picture production company for other reasons, it concurred with the industry's argument that the principal value in a motion picture lies in its intangible properties. See 371 P.2d at 343-347. Subsequently, the taxing statute (Cal. Rev. and Tax Code § 988) was amended to avoid the result in the case.

cost of a share of stock to the tangible certificate.

In attempting to minimize the copyright aspects of a motion picture and their attendant value, the court of appeals stated that the Regulation attributes all production costs "to the intangible copyright eventually procured on the positive print" (Appendix B, *infra*, p. 12a). But the copyright protections inherent in the creation of a motion picture arise before and not after the striking of the first print. As the Second Circuit long ago held in the case of motion pictures, a common-law copyright attaches to the "intellectual conception of the photoplay expressed in actions." *Universal Film Mfg. Co.* v. *Copperman*, 218 Fed. 577, 579, certiorari denied, 235 U.S. 704. In ignoring this common-law copyright which exists independent of any statutory copyright subsequently obtained, the court of appeals misconceived the nature of respondent's rights and their accompanying value in its motion pictures.[14]

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[14] The court of appeals further erred in analogizing the completed negative which is used to strike copies of a motion picture to a production machine in an automobile factory (Appendix B, *infra*, p. 13a). Whether or not the machine is patented, the court observed that the cost to produce it would be eligible for the investment credit. Focusing upon the print-making process, the court concluded that the tangible negative rather than any of the other intangible property rights of a motion picture film such as the copyright was the valuable aspect of the film. The analogy, however, is entirely inappropriate. Unlike the automobile production machine which has an intrinsic value and potential for producing income standing by itself, with or without a patent, a motion picture negative without the right to copy or exploit it has little, if any, value.

4. As further support for its decision, the court of appeals gave "special weight" to subsequent legislative history relating to the restoration of the investment credit in 1971 (Appendix B, *infra*, pp. 13a-15a). Apart from the fact that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one" (*United States* v. *Price*, 361 U.S. 304, 313),[15] the court seriously misconstrued the import of the 1971 legislative history.

While this case was still pending in the court of appeals, the view was expressed on the House floor and in the Senate Finance Committee's Report that motion picture film costs would qualify for the restored investment credit. 117 Cong. Rec. 34894; 117 Cong. Rec. 45865; S. Rep. No. 92-437, 92d Cong. 1st Sess., p. 34. While these comments support the claim that Congress intended that motion picture production costs would qualify for the restored investment credit, the court of appeals, in relying upon this history, overlooked the fact that these references to films were solely in the context of discussing *changes* in the law.[16] Indeed, under the caption "Effective

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[15] See also *United States* v. *Philadelphia Nat. Bank*, 374 U.S. 321, 348-349; *Waterman S.S. Corp.* v. *United States*, 381 U.S. 252, 269; *United States* v. *Webb. Inc.*, 397 U.S. 179, 194, n. 21; *United States* v. *Southwestern Cable Co.*, 392 U.S. 157, 170; *Rainwater* v. *United States*, 356 U.S. 590, 593; and *United States* v. *Mine Workers*, 330 U.S. 258, 280-282.

[16] The court of appeals stated that the 1971 Act did not effect a "change" in the treatment of films, because it did not change the critical phrase "tangible personal property"

dates," the Senate Report specifically states that "With respect to these provisions [which include changes "made in the treatment of: * * * motion picture and television films"], *no inference is intended* as to the proper treatment of these types of property under prior law." (Emphasis added.) S. Rep. No. 92-437, 92d Cong., 1st Sess., p. 34; see also General Explanation of the Revenue Act of 1971 (Staff of the Joint Committee on Internal Revenue Taxation), December 15, 1972, pp. 31-34.

At the very least, the consequence of the decision below will be to grant to a single industry retroactive tax relief estimated to amount to 450 million dollars. Moreover, the broad rationale of the decision could have an unsettling effect upon the applicability of both the original and the restored investment credit with respect to the costs of producing other types of creative literary property, such as books, plays and

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as used in the 1962 Act (Appendix B, *infra*, pp. 14a-15a). But it failed to recognize that identical statutory language may be construed differently when Congress desires to broaden or narrow the reach of a provision. *Commissioner* v. *Bilder*, 369 U.S. 499, 501-502, 504-505. As previously indicated, the available authorities make clear that in attributing all production costs to the intangible aspects of a motion picture, Treasury Regulations, Section 1.48-1(f), is consistent with the statutory language and the original Congressional intent that only tangible personal property qualify for the investment credit. The legislative history of the Revenue Act of 1971—reflecting an intention to make film costs eligible for the restored credit—suggests that Congress intended to expand the reach of the investment credit by carving out a legislative exception under which motion picture and television film costs are deemed to be attributable to tangible personal property.

recordings. A court should not attribute to the legislature the intention to take such a far reaching step unless there was clear evidence that it specifically intended to do so. Here, as shown above (*supra*, pp. 8-10), the legislative history of the original investment credit in 1962 shows that Congress did *not* intend to confer it upon the costs of producing motion picture films.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1973.

APPENDIX A

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

No. 70-1296-R

[Filed May 17, 1971, Clerk, U.S. District Court, Central District of California]

WALT DISNEY PRODUCTIONS, PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

MEMORANDUM OPINION

Plaintiff, Walt Disney Productions, brings this action for the recovery of federal income taxes paid as the result of the disallowance of claimed investment credit for negatives used by plaintiff as a producer of films for exhibition in theaters, on television and other non-theatrical entertainment. The theatrical films are entitled BIG RED and BON VOYAGE. Films prepared and marketed for television are CARNIVAL TIME, THE PRINCE AND THE PAUPER, VON DRAKE IN SPAIN, DISNEYLAND AFTER DARK, THE GOLDEN HORSESHOE REVUE and ESCAPADE IN FLORENCE.

Plaintiff, Walt Disney Productions, is a California corporation organized in 1938 to succeed to the business theretofore being operated by the late Walt Disney and his brother Roy O. Disney in three prede-

cessor corporations. Plaintiff's principal business activities since its organization has been in the production and distribution of motion picture films and the operation of an amusement park known as Disneyland in Anaheim, California. Business policy has largely limited the plaintiff to activities which are oriented to family entertainment, i.e., having appeal to adults as well as children.

It is the operation of the motion picture production facilities of plaintiff that brings before a court for the first time the applicability of the investment credit provisions of the Revenue Act of 1962 to motion picture film negatives. Production of a motion picture is an involved process of gathering together of story material, talent and production expertise and facilities to turn out a motion picture film negative. The motion picture film negative is then used to make positive prints rented to exhibitors for viewing by the public. It is the cost of creating the motion picture film negatives for the fiscal year ending September 29, 1962 in the sum of $1,416,573 that plaintiff claims is subject to the investment credit allowance. Plaintiff is properly before the court after having made claim for refund and denial of the claim by the Internal Revenue Service.

The parties have by stipulation confined the issues to be determined by the court:

> A. The factual question of whether each of the motion picture negatives which are the subject of this action had an estimated useful life of eight years or more when placed in service; and

B. The legal question of whether the motion picture negatives constitute tangible personal property.

1. THE USEFUL LIFE ISSUE:

The evidence amply supports a finding that each of the motion picture films herein had at the time of being placed in service a useful life of eight years and that plaintiff in good faith made such an estimate.

Plaintiff is engaged in the business of producing family entertainment. As such the film productions of plaintiff, unlike many other production companies, are not so-called "dated material", i.e., subject matter with an interest span limited by its content.

Experience of plaintiff with its productions prior to 1962 showed that most of plaintiff's films had an earning capacity in excess of eight years and, in fact, many had been reissued for theater showing and television exhibitions. That plaintiff was planning ahead is evidenced by the fact that films produced for showing on television in the black and white era of that medium were made in color in anticipation of color television reception now an accomplished fact.

Defendant points to the depreciation method of income forecast permitted by the Internal Revenue Code as binding upon plaintiff. Depreciation and its use as a "tax shelter" has a sufficient history to make one thing clear—that depreciation—as permitted by the tax laws—really has no true relationship to the life of the item depreciated—either useful or otherwise.

To apply depreciation method as a binding determination of "estimated useful life" required by the investment credit provisions of the Internal Revenue Code without specific limitations by the legislature is unrealistic and this Court declines the invitation to so legislate.

Defendant is not prejudiced by such a ruling since it is entitled to recapture of investment credits in the event plaintiff's useful life estimates prove to be erroneous. 26 U.S.C. § 47.

2. TANGIBLE PERSONAL PROPERTY ISSUE:

Title 26, United States Code, section 48 defines the property subject to investment credit. In pertinent part it provides:

> "§ 48. Special rules
>
> (a) Section 38 property.—
>
> (1) In general.—Except as provided in this subsection, the term 'section 38 property' means—
>
> (A) tangible personal property, or
> (B) * * *
> (C) * * *
>
> Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more."

The Congress in its enactment of the investment credit did not go beyond defining eligible property

as "tangible". Pursuant to the authority granted to the Secretary of the Treasury in Title 26, United States Code, section 38(b) to prescribe "such regulations as may be necessary to carry out the purposes of this section and subpart B", Treasury Regulations 1.48-1(c) provides for the definition of tangible personal property in essentially these terms:

> ". . . [F]or the purposes of this section, the term 'tangible personal property' means any tangible property except land and improvements thereto such as buildings or other inherently permanent structures (including items which are structural components of such building or structures). . . ."

To distinguish eligible tangible personal property, Treasury Regulations 1.48-1(f) defines intangible property as follows:

> "(f) Intangible property. Intangible property, such as patents, copyrights, and subscription lists does not qualify as section 38 property . . ."

Defendant then urges the following language of Treasury Regulation 1.48-1(f) as binding upon this Court in its consideration of the motion picture film negatives. Subsection (f) continues:

> ". . . The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing *the item* patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set

design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book . . ."

Defendant in urging upon the Court the binding effect of the above-quoted language misconstrues the function of the Secretary of the Treasury in two important respects: (1) The Congress gave the Secretary the power to promulgate regulations "to carry out the purposes of the Act", not to define or redefine eligible property, and (2) the determination of what is or what is not "tangible personal property", within the meaning of the investment credit provisions of the Internal Revenue Code, is for the Court, not the Secretary of the Treasury.[1] Within its constitutional powers, the Congress could have limited the definition of "tangible personal property" for tax purposes. It did not do so. Our only alternative is to assume the Congress intended the application of the ordinary meaning of tangibility. The Secretary has no power to create a new substantive definition omitted by the legislature.

The motion picture negatives here certainly are tangible—weighing between 27 and 51 pounds, between 5000 and 11,800 feet in length and capable of being seen and touched.[2] The negatives are physic-

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[1] See *Barlow* v. *Collins*, 397 U.S. 159, 166, 25 L.Ed.2d 192, 199, 90 S. Ct. 832.

[2] Tangible—1a: capable of being touched: able to be perceived as materially existent esp. by the sense of touch. Webster's Third New International Dictionary (unabridged).

ally used in the manufacture of prints which are plaintiff's stock in trade to its consumers. It is this use which establishes the eligibility as "tangible personal property".

Regulation 1.48-1(f) suffers from yet another infirmity. When the Secretary includes in cost of copyright or patents, the "costs of purchasing or producing the item patented or copyrighted," he misconstrues the very nature of patents and copyrights.

A copyright, when secured in accordance with applicable laws is the *right* to multiply copies of a literary, intellectual or artistic property.[3] Nowhere in the constitutional or statutory scheme does the law create a right by copyright *in the property.* It is an incorporeal (intangible) right existing independently from the corporeal (tangible) property out of which it arises. *Bobbs-Merrill Co.* v. *Straus*, 210 U.S. 339, 52 L.Ed. 1086 (1907); *Stephens* v. *Cady*, 14 How. 528, 14 L.Ed. 528 (1852).

Certainly that right has value—often exceeding the intrinsic value of the tangible property copyrighted. That copyright is a separate property right treated differently for accounting purposes than the copyrighted property is recognized by the Internal Revenue Code, 26 U.S.C. § 861(a)(4); 26 U.S.C. § 1221(3). To accept defendant's interpretation of copyright property would exclude "tangible personal property" where the owner of the property in order to guarantee to himself the exclusive right to reproduce the "tangible personal property" obtains a

[3] Title 17, United States Code, Section 1 et seq.

patent or copyright. The fallacy of the major premise is obvious.

Defendant further argues that Regulation 1.48-1 (f) can be read to apply only to "prototypes", i.e., the creation of a sample of the work to determine its workability. Without deciding the applicability to copyrighted and patented articles the use of that principle here cannot withstand careful scrutiny. We are not here concerned with a prototype-experimental film. The motion picture negatives which concern us are the vehicle for creation of plaintiff's stock in trade—it is *a tool* together with the reproduction processes which allows plaintiff to produce its inventory. Without *this* negative no positive print would be available to plaintiff to carry out its everyday business.

Plaintiff's motion picture negatives are entitled to treatment as tangible personal property for the purposes of the investment credit permitted by 26 U.S.C. § 38 et seq.

3. ALLOWABLE COSTS:

Although not briefed to the Court, there is a question of allowable costs for creation of the motion picture negatives. It is the view of the Court that costs allowable for computing the investment credit are only those costs which are directly related to the finished negative. To arrive at such allocable costs, the Court finds that those costs which are not affected by the footage shot, i.e., talent on a per picture basis, costs for scenery which must be expended whether the

finished product is 5000 or 6000 feet of negative, etc. Therefore, such costs as may involve hourly labor—grips, extras, etc.—shall be allowed only in relationship the final footage of negative to be used for production of positive prints bears to the total footage shot. This arises primarily from the concern of the Court that to rule otherwise would reward inefficiency in motion picture production and certainly the cut negative cannot meet the "life span" requirements established by Congress. None of the rejected footage would qualify.

Judgment shall be for plaintiff. Final recovery to abide the parties agreeing to "allocable costs" as provided herein. Plaintiff to prepare findings of fact, conclusions of law and final judgment consistent with this opinion within 45 days.

Dated: May 17, 1971.

/s/ Manuel L. Real
MANUEL L. REAL
United States District
Judge

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 72-1052

WALT DISNEY PRODUCTIONS, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

No. 72-1076

WALT DISNEY PRODUCTIONS, APPELLEE

vs.

UNITED STATES OF AMERICA, APPELLANT

[May 29, 1973]

Appeal from the United States District Court for the Central District of California

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Before: TRASK and GOODWIN, Circuit Judges, and EAST,* District Judge.

GOODWIN, Circuit Judge:

The government appeals a district court judgment in a tax-refund case allowing Walt Disney Productions to take an "investment credit" on motion-picture

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* The Honorable William G. East, United States District Judge for the District of Oregon, sitting by designation.

negatives produced in 1962. The taxpayer cross-appeals from that part of the judgment which reduced the basis of the films for purpose of the credit.

The district court held that the films were "tangible personal property" within the meaning of Internal Revenue Code of 1954; that they had a useful life of more than eight years; and that they were depreciable. The films were thus eligible for the investment credit. The Commissioner contends that the films were not "tangible personal property" within the meaning of Int. Rev. Code of 1954, § 48(a)(1)(A), and that they did not have a useful life of eight years.

The district court, in allowing Disney to take investment credit, did not allow it to take the credit on the full basis Disney used for depreciation purposes, but limited Disney to "those costs which are directly related to the finished negative," 327 F. Supp. 189, 192-93 (C.D. Cal. 1971). This figure was defined by multiplying hourly labor and certain other costs by a fraction the numerator of which was the footage of the final film and the denominator of which was the total footage shot. Disney's cross-appeal challenges this limitation of allowable costs for investment-credit purposes.

I. Investment Credit

The negatives are used to make prints, which are copyrighted, and which are exhibited in theaters or on television. The negatives are not copyrighted. They are tangible, and they are personal property. They

thus appear to be eligible for the credit. However, the Commissioner relies on Treas. Reg. § 1.48-1(f), adopted in 1964, for the proposition that all the costs of production of the negative, except the negligible costs of the raw film, are to be allocated to the intangible copyright eventually procured on the positive print. Treas. Reg. § 1.48-1(f) provides:

> "*Intangible Property.* Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the costs of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape * * *. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (b)(4) of this section."

We recognize that Treasury regulations, even interpretative regulations, "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes," *Bingler* v. *Johnson*, 394 U.S. 741, 750 (1969). However, we agree with the district court that the quoted regulation is invalid. It is plainly inconsistent with the expressed purpose of the applicable statute as shown by the legislative history.

In attributing all of Disney's labor and production costs of the negatives to the copyrighted print, the regulation defeats the purpose of the credit. For example, the same regulation, if applied to a production machine in an automobile factory, would deny the investment credit on all but the material costs of a machine developed and patented for use in the manufacturing plant although the amount paid to the inventor for the idea of the machine was insignificant and the bulk of the costs of the machine were the ordinary labor and engineering costs of its production. Disney argues that its film negatives, like the hypothetical production machines, are standardized units of depreciable property which Disney uses to produce other products, the positive prints, and that the attribution of all the value of the film to the copyright, like the attribution of all the value of a machine used in production to a patent eventually procured on it, is unwarranted. We agree.

It is evident from a reading of the legislative history of the investment credit that Congress intended the credit to be allowed to those in Disney's position. Explicit statements of legislative intent that films can qualify as tangible depreciable property are found: in the Senate Finance Committee report on the 1971 restoration of the investment credit;[1] in the

[1] "As previously indicated the investment credit is generally available for depreciable tangible personal property. Questions have arisen, however, whether motion picture and television films are tangible (as distinct from intangible) personal property eligible for the credit. A court case decided the question in favor of the taxpayer. The committee agrees with

discussion in the House on the 1971 Act in a statement by Chairman Mills of the House Committee on Ways and Means in response to a specific question from the floor, 117 Cong. Rec. 34894 (1971); and in the House debates on the 1971 Act conference report, again in a statement by Chairman Mills on the House floor in response to a specific question, 117 Cong. Rec. H-12127 (daily ed. Dec. 9, 1971).

The government urges that this legislative history is irrelevant because the 1971 Act changed prior law, or at least that the history is entitled to little weight because "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price*, 361 U.S. 304, 313 (1960). However, although the 1971 re-enactment of the investment credit did change prior law in several ways, *see, e.g.*, Revenue Act of 1971, Pub. L. No. 92-178, § 104(c), 85 Stat. 497, 501, it did not change the phrase "tangible personal property" as used in the 1962 Act, Int. Rev. Code of 1954, § 48(a)(1)(A). And, while subsequent legislative history normally is not of controlling weight, it should not be ignored when it is clearly relevant. *Haynes* v. *United States*, 390 U.S. 85, 87 n.4 (1968); *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 283 (1966); *Sioux Tribe of Indians* v. *United States*, 316 U.S. 317, 329-30 (1942); *Minot Federal Savings & Loan Ass'n* v. *United States*, 435 F.2d 1368, 1371 (8th Cir. 1970).

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the court that motion picture and TV films are tangible personal property eligible for the investment credit." S. Rep. No. 92-437, 92d Cong., 1st Sess. 34, 1971 U.S. Code Cong. and Adm. News 1941 (1971).

In this case we give subsequent legislative history special weight, because the inferences flow not from Congressional action or inaction on amendatory legislation, but from explicit Congressional statements of the meaning of a phrase which was unchanged during the period in question. In addition, Representative Mills was Chairman of the House Committee on Ways and Means both in 1962 and in 1971, and many members of the Senate Finance Committee served in both years. The statements by the Finance Committee and by Chairman Mills demonstrate that the Commissioner's regulation was contrary to the Congressional intent. We hold it invalid insofar as it denied an investment credit on the films in question.

II. Extent Of Credit

The government argues that even if the films are tangible personal property they are not entitled to the full investment credit because the films did not have a useful life of eight years or more. The government relies heavily on the difference between Disney's estimates of the useful life of the films for investment credit purposes and the period computed from Disney's "income life" estimates for depreciation purposes. However, depreciation and investment credit estimates need not be the same. *Triangle Publications, Inc.*, 54 T.C. 138, 152-3 (1970), *acquiescence*, 1972-1 Cum. Bull. 2; Rev. Rul. 72-76, 1972-1 Cum. Bull. 13. The estimate of the useful life of the films presented a difficult factual problem. The district court's resolution was not "clearly erroneous."

III. Cross Appeal

Disney's cross appeal challenges the district court's ruling limiting the basis of the films for investment credit purposes to less than their basis for depreciation. We hold that this limitation was unwarranted.

There is no indication that the term "basis" as used in § 46(c)(1)(A) was to have other than its customary meaning as including the whole cost of the property produced. Int. Rev. Code of 1954, § 1012. Indeed, the requirement in § 48(g), *repealed*, Revenue Act of 1964, Pub. L. No. 88-272, § 203(a)(1), 78 Stat. 33, that the basis for purposes of depreciation shall be reduced by the amount of the investment credit compels the conclusion that "basis" was not intended to have an idiosyncratic meaning in § 46(c)(1)(A). Accordingly, the judgment of the district court is modified to allow the taxpayer to use its depreciation basis to compute its investment credit.

Affirmed as modified.

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 72-1052

WALT DISNEY PRODUCTIONS, PLAINTIFF-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

No. 72-1076

WALT DISNEY PRODUCTIONS, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the United States District for the Central District of California. This cause came on to be heard on the transcript of the record from the United States District Court for the Central District of California and was duly submitted. On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and hereby is affirmed as modified.

Filed and entered May 29, 1973.

APPENDIX D

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[Filed Jul. 31, 1973, Dennis R. Mathews, Clerk, U. S. Court of Appeals]

No. 72-1052

WALT DISNEY PRODUCTIONS, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

No. 72-1076

WALT DISNEY PRODUCTIONS, APPELLEE

v.

UNITED STATES OF AMERICA, APPELLANT

Appeal from the United States District Court for the Central District of California

Before: TRASK and GOODWIN, Circuit Judges, and EAST,* District Judge.

ORDER

The panel as constituted in the above case has voted to deny the petition for rehearing and reject the suggestion for rehearing en banc.

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* The Honorable William G. East, United States District Judge for the District of Oregon, sitting by designation.

The full court has been advised of the suggestion for an en banc hearing, and no judge of the court has suggested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied, and the suggestion for rehearing en banc is rejected.

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC 38 [as added by Sec. 2(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) *General Rule.*—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) *Regulations.*—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

SEC. 46 [as added by Sec. 2(b), Revenue Act of 1962, *supra*]. AMOUNT OF CREDIT.

(a) *Determination of Amount.*—

(1) *General rule.*—The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

* * * *

(c) *Qualified Investment.*—

(1) *In general.*—For purposes of this subpart, the term "qualified investment" means, with respect to any taxable year, the aggregate of—

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48 (c) (1)) placed in service by the taxpayer during such taxable year.

(2) *Applicable percentage.* — For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

If the useful life is—	The applicable percentage is—
4 years or more but less than 6 years....	33 1/3
6 years or more but less than 8 years....	66 2/3
8 years or more	100

For purposes of this paragraph, the useful life of any property shall be determined as of the time such property is placed in service by the taxpayer.

* * * *

SEC. 47 [as added by Sec. 2(b), Revenue Act of 1962, *supra*]. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY.

(a) *General Rule.* — Under regulations prescribed by the Secretary or his delegate—

(1) *Early disposition, etc.* — If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by

an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

* * * *

SEC. 48 [as added by Sec. 2(b), Revenue Act of 1962, *supra*]. DEFINITIONS; SPECIAL RULES.

(a) *Section 38 Property.*—

(1) *In general.*—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property, * * *

* * * *

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

* * * *

(b) *New Section 38 Property.*—For purposes of this subpart, the term "new section 38 property" means section 38 property—

(1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

In applying section 46(c)(1)(A) in the case of property described in paragraph (1), there shall be taken into account only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961.

(c) *Used Section 38 Property.*—

(1) *In general.*—For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

(2) *Dollar limitation.*—

(A) *In general.*—The cost of used section 38 property taken into account under section 46(c)(1)(B) for any taxable year shall not exceed $50,000.

* * *

* * * *

(g) *Adjustments to Basis of Property.*—

(1) *In general.*—The basis of any section 38 property shall be reduced, for purposes of this subtitle other than this subpart, by an amount equal to 7 percent of the qualified investment as determined under section 46(c) with respect to such property.

* * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.38-1 *Investment in certain depreciable property.*

Sections 1.46-1 through 1.48-7, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 38(b) of the Code to prescribe such regulations as may be necessary to carry out the purposes of section 38 and subpart B, part IV, subchapter A, chapter 1 of the Code.

§ 1.46-1 *Determination of amount.*

(a) *In general.* Except as otherwise provided in this section and in § 1.46-2, the amount of the credit allowed by section 38 for the taxable year is equal to 7 percent of the taxpayer's qualified investment for such year (as determined under § 1.46-3). The amount equal to 7 percent of qualified investment shall be referred to in this section and §§ 1.46-2 through 1.48-7 as the "credit earned".

* * * *

§ 1.46-3 *Qualified investment.*

(a) *In general.* (1) With respect to any taxable year, the qualified investment of the tax-

payer is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus (ii) the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. With respect to any section 38 property, qualified investment means the applicable percentage of the basis (or cost) of such property. * * *

* * * *

(b) *Applicable percentage.* The applicable percentage to be applied to the basis (or cost) of property is 33⅓ percent if the estimated useful life of the property is 4 years or more but less than 6 years; 66⅔ percent if the estimated useful life is 6 years or more but less than 8 years; or 100 percent if the estimated useful life is 8 years or more. * * *

* * * *

(c) *Basis or cost.* (1) The basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) with respect to property placed in service before January 1, 1964, and any other adjustment to basis, such as that for depreciation, and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs. However, for purposes of determining qualified investment, the

basis of new section 38 property constructed, reconstructed, or erected by the taxpayer shall not include any depreciation sustained with respect to any other property used in the construction, reconstruction, or erection of such new section 38 property. (See paragraph (b)(4) of § 1.48-1.

* * * *

(e) *Estimated useful life*—(1) *In general.* * * *

* * * *

(4) *Useful life of property subject to amortization.* In the case of property with respect to which amortization in lieu of depreciation is allowable, the term over which amortization deductions are taken shall be considered as the estimated useful life of such property.

(5) *Useful life of property subject to certain methods of depreciation.* If a taxpayer is using a method of depreciation, such as the unit of production or retirement method, which does not measure the useful life of the property in terms of years, he must estimate such useful life in years in order to compute his qualified investment.

* * * *

§ 1.48-1 *Definition of section 38 property.*

(a) *In general.* Property which qualifies for the credit allowed by section 38 is known as "section 38 property". Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 4 years or more

(determined as of the time such property is placed in service), and (3) which is either (i) tangible personal property, * * *

(b) *Depreciation allowable.* (1) Property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation, including, for example, the unit of production method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. * * *

* * * *

(4) If depreciation sustained on property is not an allowable deduction for the taxable year but is added to the basis of property being constructed, reconstructed, or erected by the taxpayer, for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable for the taxable year with respect to the property on which depreciation is sustained. Thus, if $1,000 of depreciation sustained with respect to property no. 1, which is placed in service in 1964 by taxpayer A, is not allowable to A as a deduction for 1964 but is added to the basis of property being constructed by A (property no. 2), for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable to A for 1964 with respect to property no. 1. However,

the $1,000 amount is not included in the basis of property no. 2 for purposes of determining A's qualified investment with respect to property no. 2. See paragraph (c)(1) of § 1.46-3.

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings and other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display

racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

* * * *

(f) *Intangible property.* Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes manuscript and screenplay costs, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (b)(4) of this section.

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§ 1.48-2 *New section 38 property.*

(a) *In general.* Section 48(b) defines "new section 38 property" as section 38 property—

(1) The construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Which is acquired by the taxpayer after December 31, 1961, provided that the original use of such property commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of such property commenced before January 1, 1962, and completed after December 31, 1961, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. See § 1.48-1 for the definition of section 38 property.

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